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EXECUTIVE SUMMARY

Survey data were gathered from 660 board members of the largest publicly traded corporations. They think that CEO compensation is too high in many corporations. Board members believe that the most-powerful way to reduce CEO compensation levels would be to have mandatory shareholder-approval of compensation plans. Most feel that their CEO-compensation plan is reasonably effective. Board members also feel that tying pay more-closely to performance is desirable. Board members place the blame for excessive CEO-compensation levels more on consultants than the boards themselves.

Few, if any, controversial issues in American business today are more-controversial than executive compensation. Most discussion of CEO compensation revolves around two issues: First and foremost, whether it is too high, and secondarily, the degree to which it is tied to performance. Rising levels of CEO pay, generous perquisites and enormous severance packages have been lightening rods for criticism. Following another spate of high-profile cases of excessive rewards for the top executive—Richard Grasso at the New York Stock Exchange, Robert Nardelli at Home Depot and Hank McKinnell at Pfizer—pressure has been growing on regulators to reform the way in which executive compensation is determined and to reign in the increases in the pay of senior executives that occurred during the last decade.

The Securities and Exchange Commission (SEC) has made an effort to control the growth in executive compensation by introducing new guidelines requiring more-complete disclosure of the full value of the rewards and benefits packages of the five highest-paid individuals in every public company. While regulators are hoping that the combination of transparency and public pressure will curtail excessive executive pay packages, many experts in the field fear that this new data will simply facilitate benchmarking and will ratchet up CEO rewards (Zingheim and Schuster 2007).

There are some indications that the gap between top executive pay and that of the rest of the workforce is becoming even wider. The top 1 percent of earners now account for 20 percent of the United States national income, double the percentage of 30 years earlier (Ydstie 2007). And the earnings of top executives in some firms are reaching unprecedented heights as hedge funds convince more public companies to become private, offering CEOs lavish pay packages and options along with less public and regulatory scrutiny (Sorkin and Dash 2007).

The key individuals who will determine how these new rules and other external pressures ultimately affect executive compensation are the directors of public companies. And yet almost entirely missing in the research on executive compensation is research on how corporate board members view executive compensation. To say the least, their opinions should be a critical part of any analysis of executive compensation, since they have the ultimate responsibility for designing and approving executive compensation programs.

It is a particularly appropriate time to examine how board members view executive compensation. Not only are boards under greater scrutiny from the media, regulators and shareholder activists, the composition of boards changed significantly during the last five years, with a shift toward a higher percentage of independent directors. Qualified directors are getting more difficult to recruit as the time pressures, requirements for accounting expertise and the concerns regarding director liability are increasing.

Research Study

Data were gathered from 768 directors at 660 of the 2,000 largest publicly traded corporations in the United States. A survey was sent to the directors with a request that they respond in the context of the board of the largest corporation for which they were a board member. Nearly three-quarters of the respondents were outside directors, while 7.2 of the respondents were CEOs of the company they responded for. The directors, who responded, served on an average of 2.5 boards. The University of Southern California's Center for Effective Organizations and Heidrick & Struggles, an executive search and leadership consulting firm, jointly conducted the survey.

Amount of Compensation

Without question, the most-debated issue in executive compensation is the amount of CEO compensation (Murphy 1999). The amount has grown rapidly during the last two decades and has continued to increase dramatically in the last few years. Figure 1 shows board member views on whether CEO compensation is too high. The board members feel that CEO compensation is too high but disagree on whether it is a general problem (38 percent) or solely a problem in a few high-profile cases (50 percent).There are differences among CEOs and outside directors in the degree to which CEO compensation is said to be too high. Not surprisingly, CEOs in the companies surveyed are much less-likely to see CEO compensation as too high, in general, than are outside board members (9 percent versus 41 percent).

In evaluating the CEO-compensation plan for the company on which they serve as director, the responses are more positive. More than three-quarters of board members (77 percent) rate their company's CEO-compensation program as effective or very effective. This may appear surprising given the general concern board members have about CEO pay being too high, but is consistent with the finding in surveys on the other issues (for example, individuals may be critical of the education or political system in general, but feel their own school or own elected representative is doing well).

Reasons for Higher CEO Compensation

CEO compensation increased dramatically since 1980 for a number of possible reasons. Figure 2 presents data on what board members attribute the increase to. Perhaps somewhat surprisingly, according to the directors, the most-important cause is the actions of compensation consulting firms. Sixty-two percent of board members feel that the actions of compensation consulting firms were either “very important” or “extremely important.” The second most important factor is the creation of new stock and incentive compensation plans. Since compensation consulting firms have developed and sold many of the new plans that have been adopted, there is no doubt that board members feel that consulting firms have played a major role in raising executive compensation levels. Increases in executive compensation have been driven mainly by stock plans (Murphy 1999; Hall and Murphy 2003).

Directors are not willing to accept a great deal of responsibility for excessive CEO compensation— rating weak boards as only the third most important factor. This is not too surprising, since the question is being answered by board members. But it is ironic that the blame is attributed most to the consulting firms who advise boards and provide possible compensation plans, and less to the boards who hire the consulting firms and approve the “too high” compensation levels that the executives receive.

There are some predictable differences in opinions between CEOs and other board members. CEOs are less likely to see the rise in executive compensation as the result of weak boards and more likely to see it as caused by the scarcity of CEO talent, difficulty of the CEO job, and the turnover of CEOs. In other words, CEOs are much more likely to see a compensation level as the result of market conditions.

All nine of the survey’s provided explanations of the increase in CEO compensation are rated as at least “somewhat important” by at least 75 percent of the board members (see Figure 2). This suggests that board members see the rise in CEO compensation as determined by a convergence of factors, not just by a single cause or even several causes. One implication of this is that stopping or slowing the increase in executive compensation is unlikely to occur as the result of a single or regulatory policy solution, since multiple, diverse causes are driving the continuing increase.

What Determines CEO Compensation

Figure 3 shows how the directors rate the importance of various factors in determining the amount of CEO compensation in their company. The results show that the directors think it is primarily determined by an equal combination of company performance and CEO performance. To determine what to pay for a given level of performance, board members say they benchmark the pay of their CEO against the heads of peer companies. Thus, board members do acknowledge that they take into account external equity considerations in determining executive compensation level. Concerns about the public perception of CEO compensation are not seen as a major factor, nor are the actions of activist shareholder groups.

Figure 4 shows the importance that board members feel should be assigned to different determinants of CEO compensation. The results are very much in line with what board members feel currently determines CEO compensation in their firms. The greatest importance is assigned to company and CEO performance. This suggests that board members will try to further increase the relationship between pay and performance for CEOs. When asked whether they think it will increase, 85 percent said that it will.
The relationship between pay and performance is an area where board members are likely to be activists and tend to be optimistic that they can, in fact, produce change. It also is an area where change might be particularly meaningful in the public's perception of CEO compensation. Many complaints against current CEO-compensation plans are that the plans are often not obviously based on, or related to, CEO performance.

Time Spent on Compensation

When asked whether boards should spend more time on executive compensation, 71 percent of outside directors said they should. CEOs also favor spending more time, but they do not favor it as strongly (60 percent). Apparently, compensation is an issue that board members recognize needs attention and needs to be fixed. It also is an area where they think change will occur. Eighty-two percent report that they expect an increase in the amount of time that board members spend on CEO compensation.

There are multiple reasons why it is reasonable for board members to expect to spend more time on CEO compensation and why they should. As they reported, it is not tied as closely to performance as they would prefer, and of course, numerous regulatory and shareholder actions potentially could require boards to make significant changes in CEO-compensation packages. In addition, new compensation packages are being developed and sold by consulting firms, and boards are expected to vet them and decide what fits their company's situation. Finally, the continued increase in the turnover of CEOs brings the need to create new compensation packages and plans.

Expected Changes in CEO Pay

What do board members think should change about the amount of CEO compensation? Figure 5 shows that board members favor small increases or no change in all types of compensation. Thus, despite the belief that many CEOs are too highly paid, most board members feel that it is still appropriate to further increase CEO compensation. There are no significant differences in how CEOs and board members respond to these items; neither favors decreases in CEO compensation. Increases in retirement packages and severance packages find the least support, although even in this area, more directors favor an increase than a decrease, a surprising result given the enormous criticism of some large retirement packages that CEOs have received in the last few years.

When asked what they foresee *will* happen in the next three years, versus what they believe *should* happen, board members foresee no halt in the growth in CEO compensation despite public and investor criticism and government reform efforts (See Figure 6). It is clear that board members do not expect a significant decrease in any form of executive compensation. This is true whether the board member is a CEO or not. Only 5 percent expect a decline in CEO cash or stock rewards, while just one-quarter foresee any decline in perquisites or retirement packages. Of the options presented, board members think CEO severance packages are the most likely to decrease, however, that figure is only 34 percent of the respondents. Thirty-five percent think severance packages will increase despite the packages' negative publicity and the belief by most board members that the packages should either stay the same or decrease. Overall, the results strongly suggest that board members do not think there will be a significant decrease in CEO compensation despite the fact that many board members feel that CEO compensation is too high.

What Will Decrease CEO Compensation?

Proposals have been advanced about what could limit the increases in CEO compensation, or perhaps, even decrease the amount of CEO compensation. Figure 7 presents board members' reactions to six of the most frequently mentioned ways to limit CEO compensation. Two of the six stand out as approaches which are perceived as having the greatest likelihood of leading to an actual decrease in CEO compensation:

mandatory shareholder approval of all executive compensation programs and tying pay more closely to performance.

CEOs rate four approaches in Figure 7 as being less-likely to lead to a decrease than do outside directors. They don't differ on shareholder approval or independent board chairs. The biggest difference between CEOs and board members is on having fewer CEOs on boards.

One of the most effective ways to decrease compensation of some CEOs is within the control of board members. The board can tie pay more closely to performance and thus reduce the compensation of poorly performing CEOs. Mandatory shareholder approval of all executive compensation programs will take a regulatory or legislative action to be put in effect. It is easy to understand why board members would think this might limit or reduce executive compensation given the amount of shareholder activism existing around the current, high levels of executive compensation. It is quite possible that boards would be much more conservative in the plans that they create if they knew that the shareholders were going to have a vote on the plans.

One currently popular way to reduce and control executive comp plans is better disclosure of the plans. As can be seen in Figure 7, this is not seen by board members as a particularly powerful way to decrease CEO compensation. This result raises serious questions whether the SEC's recent moves to mandate full disclosure of executive compensation will, in fact, have the desired effect of reducing CEO pay. Apparently, public criticism and vetting may not get board members to decrease CEO compensation. It appears that any pressure on boards and the companies they oversee from public disclosure are outweighed, in the directors’ minds, by the need to offer packages that will allow them to attract, retain and motivate the best executive talent in a highly competitive labor market.

Conclusion

Many board members think CEO compensation is too high and should be more closely tied to performance. Nevertheless, major changes in either the level or the form of executive compensation are by no means certain. As the board members themselves point out, the most-powerful change that would produce a reduction in compensation levels is mandatory shareholder-approval of compensation plans. This is not likely to be a provision that will become mandatory in the next few years, and until it is, there may not be enough pressure on boards to cause the boards to reduce CEO compensation. Change is particularly unlikely, given that most board members feel that their company’s CEO-compensation plan is reasonably effective. In their minds, the problem is with other companies, not theirs (Conger, Lawler and Finegold 2001).

Some board members appear to recognize that problems exist with CEO-compensation plans in U.S. corporations. The plans have the wrong mix of compensation, too much in severance packages and nonincentive pay. Board members clearly do feel that tying pay more closely to performance is desirable and they may make some successful efforts in this direction. But, based on their survey responses, there is little reason to believe that, during the next few years, boards will take actions to reduce or reverse the upward trend in executive compensation that has unfolded during the last 20 years in the United States. Board members don't feel that the blame for too high CEO-compensation levels should be directed toward corporate boards. Even though they approve all CEO pay packages, they believe consulting firms are the most important cause. Thus, executive compensation is likely to will continue to rise until some major reforms (such as, mandated votes on shareholder plans, punitive penalties on "excessive" executive compensation and/or far more intense shareholder activism) cause board members to act differently in the area of CEO compensation.

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FIGURE 1   Responses to Question Regarding the Amount of CEO Compensation

	Too High in Most Cases	About Right Except for a Few High Profile Cases	Generally in Line with Performance, Competitive Conditions and Good Economics	Too Low in the Majority of Cases
All board members 768 responses	38%	50%	12%	0%
CEOs 55 responses	9%	75%	16%	0%
Outside directors 663 responses	41%	47%	12%	0%

FIGURE 2 Responses to the Question: "How Important Do You Think the Following Have Been in Increasing CEO Compensation since 1980?"

	Not Important At All	Somewhat Important	Important	Very Important	Extremely Important
The actions of compensation consulting firms	3%	12%	23%	36%	26%
Creation of new stock and incentive compensation programs	2%	10%	27%	45%	16%
Weak boards	9%	25%	23%	29%	15%
Scarcity of CEO talent	23%	27%	25%	18%	7%
Increased emphasis on pay for performance	6%	21%	31%	35%	8%
Increase in the difficulty of the CEO's job	10%	21%	31%	29%	9%
Board's lack of understanding of compensation programs	18%	30%	26%	21%	5%
Lack of public information about CEO pay plans	21%	29%	26%	19%	6%
Turnover of CEOs	15%	29%	32%	19%	4%

FIGURE 3 Reponses to the Question Asking Board Members What Determines the Level of CEO Compensation in Their Company.

	Not Important at All	Somewhat Important	Important	Very Important	Extremely Important
Company performance	0%	2%	11%	40%	46%
CEO performance	1%	3%	12%	41%	43%
Pay of CEOs in peer companies	2%	15%	41%	33%	9%
Pay of the employees in the company	15%	36%	36%	12%	2%
Concern over the public perception of CEO compensation	17%	42%	28%	11%	2%
Activist shareholder groups	58%	31%	10%	2%	0%

FIGURE 4 Reponses to the Question Asking Board Members What Should Determine the Level of CEO Compensation in Their Company.

	Not Important At All	Somewhat Important	Important	Very Important	Extremely Important
Company performance	0	0	4	29	66
CEO performance	0	0	4	29	67
Pay of CEOs in peer companies	4	25	46	21	5
Pay of the employees in the company	9	29	41	19	2
Concern over the public perception of CEO compensation	19	40	29	10	2
Activist shareholder groups	52	35	11	2	0

FIGURE 5 Responses to the Question Asking How the Amount of CEO Compensation Should Change in the Future.

	Major Decrease	Small Decrease	No Change	Small Increase	Major Increase
CEO cash compensation	3%	8%	42%	40%	7%
Benefits and perquisites for CEOs	6%	16%	36%	31%	10%
CEO stock-based compensation	4%	9%	36%	38%	13%
CEO retirement packages	9%	16%	41%	24%	10%
CEO severance packages	18%	14%	34%	22%	11%

FIGURE 6 Reponses to the Question Asking What Will Change in the Next Three Years in CEO Compensation

	Major Decrease	Small Decrease	No Change	Small Increase	Major Increase
CEO cash compensation	1%	4%	32%	52%	12%
Benefits and perquisites for CEOs	4%	21%	29%	32%	14%
CEO stock-based compensation	2%	12%	29%	38%	19%
CEO retirement packages	6%	19%	38%	25%	12%
CEO severance packages	11%	23%	32%	21%	14%

FIGURE 7 Responses to Question Asking What Factors Are Likely to Lead to a Decrease in CEO Compensation

	To a Very Small Or No Extent	To a Small Extent	To Some Extent	To a Great Extent	To a Very Great Extent
Full disclosure of executive compensation programs	24%	28%	33%	12%	3%
Mandatory shareholder approval of all executive compensation programs	9%	16%	25%	31%	19%
More independent boards	19%	26%	35%	16%	4%
Independent board chairs	28%	27%	29%	12%	3%
Fewer CEOs of other companies on boards	25%	28%	28%	15%	4%
Tying pay closer to performance	9%	16%	36%	28%	11%